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More Difficult to Obtain in 1983

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The general trend in recent years has been to increase the difficulty of obtaining any tax relief from medical expense deductions. By the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 and other proposed changes to the Internal Revenue Code, it is obvious that the government is attempting to limit medical care deductions to some sort of catastrophic category. These changes make it especially necessary for professional tax planners to be aware of the historical trends and law in this vital area.

History of IRC 213

During the Second World War, Congress, basing its actions upon statistical data which had been collected since the time of the New Deal, enacted Section 23X of the 1939 Internal Revenue Code which provided for the first medical expense deduction in American history.[1] These deductions which were part of the Revenue Act of 1942 were designed to help taxpayers with difficult medical situations during World War II. The report of the Senate Finance Committee, for example, stated that "this allowance is recommended in consideration of the heavy tax burden that must be borne by individuals during the existing emergency and of the desirability of maintaining the present high level of public health and morale."[2] The 1942 law originally limited the deduction to non-reimbursed medical expenses which were not to exceed 5 per cent of net income. These deductions were further limited to a total of $2,500 for a married couple and $1,250 for other classes of taxpayers.[3] These provisions were made somewhat more generous in 1944 when the law was amended to provide 5 per cent of adjusted gross income rather than 5 per cent of net income. Further amendments in 1948 provided that the amount deductible could equal $1,250 per exemption with a dollar cap of $2,500 for single taxpayers and $5,000 for those filing joint returns.[4]

During the next twenty years, additional steps were taken to liberalize the medical expense deduction. In 1951, Congress generally abolished the 5 per cent limit for taxpayers over the age of sixty-five and allowed them to deduct amounts for other dependents which exceeded 5 per cent of adjusted gross income.[5] The percentage limitation was further reduced in 1954 when Congress adopted a new Code. President Eisenhower's recommendation for a 3 per cent limitation was adopted and the overall limitation on deductions was raised to $5,000 for a single taxpayer and $10,000 for those taxpayers filing joint returns, head of household, or surviving spouses. The 1954 Code also required that the deductible portion of drugs and medicine exceed 1 per cent of adjusted gross income.[6] Further liberalization of the limits on deductions occurred in 1958 and 1962, and the overall limitation on the deductibility of medical expenses was removed by the Social Security Amendments of 1965.[7] Efforts to limit the medical expense deduction were suggested in the late 1970's during the Carter administration but it was not until the Tax Equity and Fiscal Responsibility Act of 1982 that the limits on medical deductions were raised again to allow deductions only for expenses in excess of 5 per cent of adjusted gross income. Congress eliminated the 1 per cent of adjusted gross income requirement for drugs as of 1984 but also limited the deduction for drugs and medicine to only those prescribed by a physician or insulin.[8] Congress has thus come full cycle as it has returned to a harsher definition of medical expenses which is more attuned to the limits first enacted as a war emergency measure in the 1940's.

Current Definition of Medical Expenses

The current definition of a medical expense includes all monetary amounts paid "for the diagnosis, cure, mitigation, treatment or prevention of disease, or for the purpose of affecting any structure of the body."[9] This definition has been further expanded by Regulations which state that "medical care includes...transportation primarily for and essential to medical care."[10] This broad definition, which is contained in IRC 213, converts personal payments for medical expenses to various health care providers into deductible medical expenses.

Payments for medical expenses can be made to a wide variety of health care providers ranging from surgeons, psychologists, and nurses, to acupuncturists.[11] The payments must usually be made for care within the tax year and may include expenditures for hospital care, nursing services, outpatient medical services, and other general medical services. These payments for broad medical services may not be for general health products or for general medical services needed to maintain one's overall health. Thus, certain toiletries, such as toothpaste or travel to Florida for rest and relaxation, will not quality for a deduction even if undertaken on the advice of a licensed physician. If a health care provider recommends that an individual taxpayer lose weight to improve his or her general health, it would not be deductible. However, if the weight loss requires special treatment, it will be allowed if it is to alleviate a special health problem, such as acute hypertension.[12]

Travel as Medical Expenses

During the period from 1942 to 1954, these were conflicting interpretations over the deductibility of medical costs for travel, meals, and lodging. In *Havey,*[13] a taxpayer suffered from a major heart attack and specific lung problems which caused his licensed physician to recommend a move to Arizona in the winter and to a residence at the seashore in the summer. Havey deducted the costs of the travel, meals, and lodging. The Tax Court held that only those travel expenses which were definitely related to medical expense as opposed to personal expenses, such as vacations, were deductible. There were a number of other cases which ruled both for and against meals and lodging of particular taxpayers. However, both the courts and Congress recognized by 1954 that abuses might continue under the 1939 Code. For instance, in *Hoffman,*[14] a taxpayer deducted the entire costs of education for her son attending UCLA since she maintained that the general climate of southern California was necessary for her son's health. The Court held that "if we were to hold here, under the facts, that the expenses in question are deductible by the petitioner under 23(x), it would follow as a matter of logic...that the expenses of his meals and lodging in a later year or years would be deductible..."[15] The Code in 1954 (Sec 213(d)(1)(B)) held that medical care means "amounts paid...for transportations primarily for and essential to medical care..." The reasons for deductibility of meals and lodging were outlined in a House Report which explained that "the deduction...clarifies existing law in that it specifically excludes deductions for any meals and lodging while away from home receiving medical treatment. For example, if a doctor prescribes that a patient must go to Florida in order to alleviate specific chronic ailments...and the travel is prescribed for reasons other than improvements of a patient's health, the cost of the patient's transportation to Florida would be deductible but not his living expenses while there."[16] After the enactment of the 1954 Code, the Second Circuit in *Carasso*[17] denied the cost of meals and lodging while the Third Circuit reached an opposite conclusion in *Commissioner* v. *Bilder.*[18] The Supereme Court noted the conflict between the Circuits in 1962 and disallowed meals and lodging expenses as medical expenses on the strength of the legislative history of IRC 213. Since 1962 various courts have not allowed living expenses except when traveling to a destination for medical purposes.[19]

Local and long distance medical travel itself is also deductible. Travel cost whether by cab or personal vehicle is deductible at a standard rate of 9 cents per mile or the actual expenses if higher. Several unusual expenses have been allowed, however. Thus, a spouse's medical transportation expenses from her home and back to a hospital in another city to visit her husband were allowed since it was to provide nursing care based upon a physician's request. Additionally, the cost of a taxpayer's travel to an Alcoholics Anonymous meeting was deductible since attendance was based upon medical advice. In contrast, travel expenses for a handicapped person (e.g. commuting to work) are not deductible as a medical expense where the expense is not specifically prescribed for therapeutic reasons.[20]

Capital Improvements

It is a general rule that capital expenditures by a taxpayer are not deductible (Sec IRC 263). However, the Code allows certain capital expenditures as deductible medical expenses even if they are improvements or betterments to the property of the owner. The Regulations list such obvious items as wheel chairs and note that even "a capital expenditure for permanent improvement or betterment of property

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which would not ordinarily be for the purpose of medical care...may, nevertheless, qualify as a medical expense to the extent that the expenditure exceeds the increase in value of the related property..."[21] Thus, for example, if an elevator cost $10,000 to install and was required for medical purposes for a heart patient, it would be deductible to the extent it exceeds the increase in value to the taxpayer's house.

Litigation in the capital expenditure area has produced some very interesting results. The Internal Revenue Service, in Rev Rule 54-57,[22] held that the cost of an air conditioner and its operating expenses are deductible medical expenses if they are primarily to alleviate a medical problem and the device is not permanently attached to the dwelling. Litigation in *Gerard*[23] resulted in the Tax Court upholding the deduction for a permanent attached central air conditioning unit for the relief of a taxpayer's dependent who was suffering from cystic fibrosis. In contrast to these two cases, a deduction was not allowed for the cost of an oil heater to replace a coal furnace where the taxpayer suffered from bronchial asthma even though the heater was installed on the advice of a doctor.[24]

The potential for abuse in the capital expenditure area is quite prevalent. Perhaps the most infamous case in this area is *Ferris.*[25] The taxpayer, who was suffering from a back problem, was advised to swim twice daily in order to prevent deterioration and paralysis. Ferris built a $194,000 pool which included a bar, sauna, and terrace. These "unnecessary" items were subtracted from the deductible amount as was an expert appraiser's estimate of the additional increase in value to the property. However, the taxpayer was still entitled to deduct $86,000 which was upheld over IRS protests in the Tax Court. The Seventh Circuit reversed the decision of the Tax Court on grounds of reasonableness of the expense and stated: "The task in cases like this one is to determine the minimum reasonable cost of a functionally adequate pool and housing structures. Taxpayers may well decide to exceed that cost and construct a facility more in keeping with their tastes, but any costs above those necessary to produce a functionally adequate structure are not incurred 'for medical expense'."[26] This standard does seem necessary but the court did not cite any substantive requirement in the law, legislative history, or regulations.

Capital expenditures must, therefore, meet several requirements. They must be related to a specific medical problem of the taxpayer. Secondly, the deduction may include operating expenses but the cost of the capital item is deductible only to the extent it exceeds the value of the improvement. Finally, a test of reasonableness of expense may appear in the case of certain capital expenditures such as swimming pools.

Medicine and Drugs

Currently, a medical deduction is allowed for medicine and drugs to the extent the legitimate cost exceeds 1 per cent of adjusted gross income. These "medical" expenses may be either for prescription drugs and nonprescription medicine. Beginning 1984, a deduction will be allowed only for prescription drugs and insulin. The deductibility of items, such as toothpaste and vitamins for general health, has never been allowed. However, vitamins prescribed by a physician (even if non-prescription) and such items as aspirins or cold pills are currently deductible if they exceed the 1 per cent and 3 per cent limitations. This 1 per cent deduction limitation will be eliminated in 1984.[27]

Insurance Premiums

Beginning with 1983, the "guaranteed" deductibility of up to one-half of the medical insurance premium (maximum deductibility of $150) of a taxpayer has been repealed. Medical insurance premiums are still deductible as an expense but only to the extent that they exceed 5 per cent of adjusted gross income.[28]

Insurance is an especially critical area for medical expenses. If a taxpayer is reimbursed for medical expenses, he may deduct only the portion of the total medical payments for which he is not compensated. If the expenses are incurred at the end of a taxable year, and the reimbursement occurs in the next year, the reimbursed amount must be taken into income in the year it is received. Finally, a deduction is allowed for the cost of insurance premiums paid to cover medical expense when the taxpayer reaches age 65.[29]

Dependents and Medical Expenses

A taxpayer is entitled to a medical expense deduction for himself or herself, for a spouse, or any other dependent. According to the Regulations, a person will be considered a spouse if that person is married to another at the time the medical services are rendered or paid. In the case of dependents, the rules for determining dependency apply even to an adopted child or even if the individual has income in excess of $1,000 as long as the other dependency tests are met.[30]

Tax Planning

One of the great difficulties for employees is the deduction of medical expense for 1983 which must exceed 5 per cent of adjusted gross income. Any employee, for example, whose medical expenses are below that amount and not reimbursed will lose the medical deduction. Congress has chosen to reduce this tax deduction while at the same time not providing for any comprehensive medical care insurance as was proposed under the Carter administration. Since tax benefits from medical deductions will be more difficult for 1983, planning is essential.

Timing and payment of medical expenses is especially important for 1983. Taxpayers should be encouraged to time any discretionary medical treatment so that the totals will help them exceed the 5 per cent limitation. If cash is not readily available, any unpaid medical bills may be paid by credit card. Secondly, although it is a general rule that medical expenses are only deductible for the current year, it is probable that prepaid expenses may be deductible if the taxpayer is under the obligation to pay them to a health care provider or institution. Further, taxpayers should be encouraged to purchase extra health insurance to cover catastrophic illness and to supplement their employer's coverage.[31]

Business should also be aware of the alternatives which will provide tax planning opportunities for them in the medical expense area. It is possible, for example, that employers will want to encourage their employees to select from a range of medical care options through the use of so-called cafeteria plans under IRC 125. The various options under a cafeteria arrangment can cover everything from a self insured medical reimbursement plan offered by the company to participation in a Health Maintenance Organization (HMO). IRC 105(b) provides that employee medical expenses may be excludable from income if received as part of a health and accident plan. These plans may be insured or uninsured which provides the employer with some flexibility. Uninsured plans may not discriminate in favor of highly paid employees (e.g. employer-shareholder in a closely held corporation). If the uninsured plan discriminates in favor of highly compensated employees in medical coverage, any additional amounts paid for their medical expenses will be included in their gross income as "excess reimbursements."[32]

If the employer wants to provide coverage for the "key employee", the following tax planning strategies might be followed: Two separate self insured plans might be established with the "key employee" plus enough other employees in one plan to meet the non-discrimination tests allowed in IRC 105(h). A second option would be to remove the key employee from the self insured plan and cover them under an insured plan which is not subject to IRC 105. A final strategy might simply be to reimburse these employees of the cost of their individually acquired medical insurance.[33]

Finally, self insured plans can be useful for the sole proprietor who employs a spouse. The spouse can be covered under a self insured plan along with any children. The proprietor is then covered as the spouse of the wife-employee, and the cost of the medical reimbursement is a deductible business expense under IRC 162 which places it outside the requirements of the personal medical deduction rules of IRC 213.[34] Ω

NOTES

[1]IRC (1939) 23X. Historical and other coverage in this article is based upon primary sources, Comford and Sacks, *Federal Tax Deductions* (1983), Mertens, *Law of Federal Income Tax*, and Newman, "The Medical Expense Deduction: A Preliminary Post-mortem," 53 *Southern California Law Review* 787 (1980).

[2]Sen. Rep. No. 1631, 77 Cong., 2 Sess., 6, 95-96.

[3]IRC (1939) 23X.

[4]Sec. 8(c) of the Individual Income Tax Act of 1944; Sec. 304, 1948 Act, effective for tax years beginning after December 31, 1947.

[5]Sec. 307(a), 1951 Act, effective for tax years beginning after December 31, 1950.

[6]The President's Budget Message for 1955, 100 Cong. Rec. 570 (1954); IRC 213.

[7]IRC (1954) Sec. 213(g), added by Sec. 17(a) of the Technical Amendments Act of 1958; IRC 213(c) as amended by Sec. 1(a) of Pub. Law 87-863, 87 Cong., 2 Sess.; IRC 213(c) and (g) repealed by Sec. 106(d)(1) of the Social Security Amendments of 1965, Pub. Law 87-97, 89 Cong., 1 Sess. (1965).

[8]House Rep. 12078, 95 Cong., 2 Sess. (1978); Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), (Pub. Law 97-248, September 3, 1982).

[9]IRC 213(d)(1)(A).

[10]Reg. 1.213-1 (e)(1)(i).

[11]Reg. 1.213-1(e)(1) and (2); Rev Rule 55-261, 1955-1 CB 307; Rev Rule 72-593, 1972-2 CB 180.

[12]Reg. 1.213-1(e) (1) and (2); Rev Rule 79-151, 1979-1 CB 116; Rev Rule 79-162, 1979-1 CB 116; Ltr. Rule 8004111 (1979).

[13]Havey, 12 TC 409, (1949).

[14]Hoffman, 17 TC 1380, (1952). Historical coverage in this subsection is based upon primary sources and the Newman article cited in Footnote 1.

[15]Id at 1386.

[16]House Rep. No. 1337, 83 Cong., 2 Sess., A59-A60.

[17]Carasso, 292 F.2d 367 (CA2, 1961).

[18]Bilder, 289 F.2d 291 (CA3, 1961), rev'd 369 U.S. 499 (1962).

[19]Montgomery, 428 F.2d 243 (CA6, 1970).

[20]Rev Proc. 80-7, 1980-1 CB 590 as modified by Rev Proc. 80-32, 1980-2 CB 767, as further modified by Rev Proc. 81-54, 1981-2 CB 649; Daniel S. W. Kelly, TC Memo 1969-231; Rev Rule 62-273, 1963-2 CB 112; Rev Rule 55-261, 1955-1 CB 307; Ginsberg, 237 F. Supp. 968 (DCSDNY, 1964).

[21]Reg. 1.213-1(e)(1)(iii).

[22]1954-1 CB 67.

[23]37 TC 826 (1962).

[24]John L. Seymour, 14 TC 1111 (1950).

[25]Ferris, 582 F. 2d 1112 (CA7, 1978), rev'g and remanding 36 TCM 765 (1977).

[26]Id at 1116.

[27]IRC 213(b); Reg. 1.213-1(e)(2), the Tax Equity and Fiscal Responsibility Act of 1982 changed the rules for tax deductibility of medicine and drugs; IRS Pub. 17 (1982), p. 86.

[28]The Tax Equity and Fiscal Responsibility Act changed IRC 213(a) on the deductiblity of insurance premiums.

[29]Reg. 1.213-1(e)(4)(i)(b); Reg. 1.213-1(g)(1); IRC 213(a).

[30]IRC 151 and 152; Reg. 1.213-1(a)(3)(i); Reg. 1.213-1(e)(3).

[31]IRC 213 (d); Rev Rule 78-39, 1978-1 CB 73; Bassett 26 TC 619 (1956); Rev Rule 75-302, 1975-2 CB 86.

[32]IRC 105(h); IRC 105(b); Reg. 1.105-11(b)(2); Reg. 1.105-11(d); Reg. 1.105-11(c)(2)(iii)(A).

[33]Maldonado, "Using Multiple Plan to Ease Nondiscrimination Rules of Medical Expense Reimbursement Plans" 30 *Taxation for Accountants* 198 (April 1983) for more detailed coverage.

[34]Rev Rule 71-588, 1971-2 CB 91.

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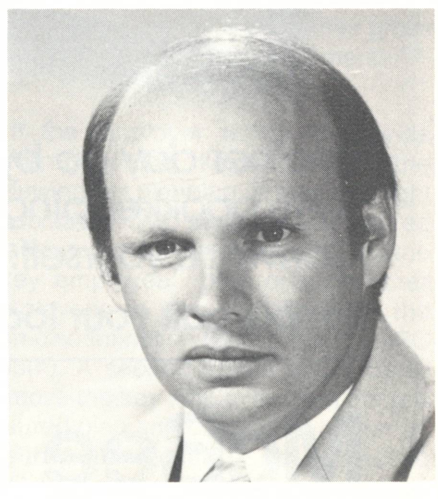

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